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No.

Supreme Court, U.S.
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In the Supreme Court of the United States

OCTOBER TERM, 1986

UNITED PACIFIC INSURANCE COMPANY,
Petitioner,

vs.

LAUREL COUNTY, LAUREL COUNTY FISCAL COURT AND LAUREL COUNTY BOARD OF EDUCATION,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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May 1, 1987

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QUESTIONS PRESENTED

Whether the federal tax lien attaches to progress payments held by the owner under a construction contract where the contractor has defaulted and the performance and labor and material payment bond surety is subrogated under state law to the rights of the owner and laborers and materialmen?

Whether an owner which pays over to the Internal Revenue Service pursuant to levy progress payments held by it under a construction contract is liable to a performance and labor and material payment bond surety which is subrogated to the rights of the owner and laborers and materialmen?

LIST OF PARTIES

The parties to the proceeding in the Court of Appeals were the Commonwealth of Kentucky for the benefit of United Pacific Insurance Company and United Pacific Insurance Company, Plaintiffs-Appellees; Laurel County and Laurel County Fiscal Court, Defendants and Third-Party Plaintiffs-Appellants; Laurel County Board of Education, Defendant-Appellant; and the United States of America, Third-Party Defendant-Appellee. United Pacific Insurance Company is a wholly-owned subsidiary of Reliance Insurance Company, which, in turn, is a wholly-owned subsidiary of Reliance Group Holding Incorporated.

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vs.

LAUREL COUNTY, LAUREL COUNTY FISCAL COURT AND LAUREL COUNTY BOARD OF EDUCATION,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

The petitioner, United Pacific Insurance Company, respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Sixth Circuit entered in this proceeding on November 14, 1986, as amended on motion for rehearing on February 4, 1987.

OPINIONS BELOW

The opinions of the Court of Appeals for the Sixth Circuit and of the District Court for the Eastern District of Kentucky, which are not yet reported, appear in the Appendix at pages A1-A21 and A22-A30, respectively.

JURISDICTION

The judgment of the Court of Appeals for the Sixth Circuit was entered on November 14, 1986. A timely petition for rehearing was filed, an Order of Amendment modifying the decision was entered on February 4, 1987, and this petition for certiorari was filed within 90 days of that date. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

STATUTORY PROVISIONS AND REGULATIONS INVOLVED

This case involves construction and application of 26 U.S.C. §§6321, 6323(i) and 6332(d) and regulations promulgated pursuant to such statutes. The full text of the relevant portions of such statutes and regulations are printed in Appendix D at pages A31-A33.

STATEMENT OF THE CASE

On March 7, 1969, the Laurel County Fiscal Court and the Laurel County Board of Education executed a contract with Y&S Construction Company, Inc. for construction of a senior high school building complex in London, Kentucky, for a total price of $2,524,250.00. The General Conditions of the contract provided that in the event the contractor defaulted the owner could itself continue construction, deducting the cost of completion from the contract balance. They also allowed the owner to withhold payment to the contractor for its failure to pay laborers or materialmen or for other defaults. On the same date Y&S provided a performance bond and a

labor and material payment bond, both in the contract amount, binding Y&S and United Pacific Insurance Company, as surety, to the Laurel County Fiscal Court to secure performance of the construction contract and payment of labor and material suppliers to the project. Construction of the project was commenced by Y&S, and twelve periodic payment requests were tendered, approved by the architect and paid to Y&S totaling $1,764,478.92, of which 10% was retained, as provided by the contract, by the project owner. The project was about 75% completed at the time application was made for the thirteenth payment.

On February 4, 1970, the Internal Revenue Service filed with the Laurel County Clerk's Office a Notice of Tax Lien in the amount of $185,031.05 against Y&S Construction Company, Inc., for nonpayment of withholding taxes for the third quarter of 1969. A second Notice of Tax Lien was filed on March 11, 1970, in the amount of $162,718.64 for the fourth quarter of 1969.

On or before March 4, 1970, Y&S defaulted in the performance of the contract. On March 4, 1970, United Pacific sent a certified letter to the architect and owner's representative requesting that no further contract funds be paid to Y&S without the surety's written consent. On March 15, 1970, Y&S sent notices to the Laurel County Fiscal Court and its architect directing that all funds then due or thereafter to become due on the construction project be paid to United Pacific, as surety. Both the Laurel County Fiscal Court and the architect confirmed in writing to United Pacific that they would comply with this directive.

On April 1, 1970, United Pacific submitted Application for Payment No. 13, requesting payment in the amount of

$116,666.59, after 10% retainage, for work completed on the project. This application was approved on April 17, 1970. By telegram on May 15, 1970, United Pacific demanded payment for all sums due under the contract. On May 18, 1970, the Laurel County Fiscal Court, however, issued a check for $100,833.91 to the Internal Revenue Service drawn on the Y&S project account, purportedly pursuant to a tax levy against property of Y&S. United Pacific protested the IRS levy payment by letter of June 1, 1970, to the County Treasurer. Thereafter, the surety completed construction of the high school building under the terms of the original contract. The parties have no claim against each other except for the payment to the Internal Revenue Service. United Pacific expended sums in excess of $100,833.91 over and above the remaining contract balance of $865,703.21 in fulfilling its obligations under the performance and payment bonds.

Petitioner United Pacific then filed this diversity action in the United States District Court for the Eastern District of Kentucky to recover the amount paid to the Internal Revenue Service by the Laurel County Fiscal Court. The jurisdiction of the District Court was invoked under 28 U.S.C. §1332 because of diversity of citizenship, petitioner being a citizen of the State of Washington and respondents citizens of the Commonwealth of Kentucky and there being more than Ten Thousand Dollars in controversy. The District Court entered judgment in favor of United Pacific in the amount of $100,833.91 plus interest, holding that under Kentucky law the funds due under the contract were held in trust for the benefit of unpaid materialmen and that the surety, whose rights accrued as of the time of execution of the bonds, was subrogated to all rights of the owner, laborers and materialmen to funds due under the contract. Consequently, Y&S as the

taxpayer had no "property" or "rights to property" in the funds due under the contract. The District Court also held that respondents were not relieved of liability for their payment to the Internal Revenue Service.

The Court of Appeals reversed on the ground that Kentucky law did not create a trust in funds due under the contract for the benefit of unpaid materialmen, that the taxpayer, consequently, had "property" or "rights to property" in the funds, and that the respondents were relieved of liability for their payment to the Internal Revenue Service because the payment was not mistaken. The Court of Appeals did not address the effect of the Petitioner's subrogation rights (Appendix A).

REASONS FOR GRANTING THE WRIT

1. The Decision Below Conflicts in Principle With Decisions of This Court As to the Nature and Effect of the Surety's Subrogation Rights in Contract Funds.

The subrogation rights of a surety to contract funds have long been recognized by this Court. In *Prairie State Nat. Bank v. United States*, 164 U.S. 227 (1896), a surety who completed performance of a federal construction contract upon default by the principal sought to recover the ten percent retainage held by the government in accordance with the contract. This Court held that the surety was entitled to assert the doctrine of subrogation which allowed it to resort to the securities and remedies of the United States. Among these were the right to appropriate the ten percent retainage in order to complete the contract. The surety's subrogation right was held to be superior to the rights of a bank which had been

given a power of attorney by the contractor authorizing it to receive final payment on the contract. Similarly, in *Henningsen v. United States Fidelity & Guaranty Co.*, 208 U.S. 404 (1908), a surety which paid the claims of laborers and materialmen upon a contractor's default was held to have an equity in amounts due under the contract superior to that of a bank which received an assignment of contract proceeds to secure a loan to the contractor, based on the *Prairie State Nat. Bank* decision.

More recently, in *Pearlman v. Reliance Insurance Company*, 371 U.S. 132 (1962), this Court followed the "firmly established rule" that a surety which completes performance of a contract is subrogated to the rights of the owner in contract funds and that a surety which pays laborers and materialmen is, likewise, subrogated to their rights in contract funds. Consequently, it held that those funds did not become vested in the trustee in bankruptcy of a defaulted contractor because

> [p]roperty interests in a fund not owned by a bankrupt at the time of adjudication, whether complete or equitable, mortgages, liens, or simple priority of rights, are of course not a part of the bankrupt's property and do not vest in the trustee.

Id. at 135.

Thus, *Pearlman* stands for the proposition that the contractor has no property interest in contract funds because a surety which completes performance of a contract or which pays laborers and materialmen is subrogated to the rights of the owner or laborers and materialmen.

It is important to consider what rights the owner had to which United Pacific was subrogated. By specific provisions contained in the General Conditions of the

contract, the owner was allowed, in the event of default by the contractor, to continue construction and deduct the cost of completing the work from the contract balance. The General Conditions also provided that the owner could withhold progress payments if the contractor failed to pay laborers or materialmen or otherwise defaulted and nullify previously issued certificates of payment to protect itself from loss.

The significance of these provisions, which establish that the contractor does not have a property right to progress payments, was discussed in *Fidelity & Casualty Co. of New York v. Dykstra,* 208 F.Supp. 717 (D. Minn. 1962), where a highway construction contractor defaulted in payment of laborers and materialmen and the surety completed the contract and paid these charges. A dispute arose between the Internal Revenue Service and the surety as to which was entitled to contract balances held by the owner, the State of Minnesota. The court, noting that the owner had the right by contract to withhold payment from the contractor until receipt of proof of payment of all claims against the job, held that the funds held by the owner were not the property of the construction company. Consequently, the court ruled that there was no property to which the lien of the United States could attach.

Kentucky follows *Pearlman.* In *National Surety Corp. v. State Nat. Bank of Frankfort,* 454 S.W.2d 354 (Ky. 1970), the Kentucky Court of Appeals overruled prior Kentucky cases which were contrary to "the great weight of authority" and held that, ordinarily, a bonding company is entitled to be subrogated to the rights of the contractor in proceeds of the contract as against one asserting claims for money loaned or advanced to the building contractor, citing *Pearlman* and *Prairie State Nat. Bank, supra.* Furthermore, even before the *National Surety Corp.* case, *su-*

pra, the Sixth Circuit Court of Appeals upheld the surety's rights in a very similar case to the instant one. In *Glenn v. American Surety Co.,* 160 F.2d 977 (6th Cir. 1947), the surety for a contractor who defaulted in payment of labor and material claims brought suit to restrain the owner, the Louisville Municipal Housing Commission, from paying delinquent federal taxes out of sums the owner had withheld from payment to the contractor. A notice of levy and a warrant for distraint for the taxes were served on the owner after completion of the contract. The court held in favor of the surety on the ground that

> a surety who makes good under his contract of suretyship upon default of the principal contractor, acquires an equitable lien against the unpaid balance in the hands of the person in whose favor the bond runs, and . . . such equitable lien upon payment by the surety relates back to the date of the contract and is superior to a claim of the United States for unpaid taxes for periods subsequent to the date of the contract of suretyship, although prior to the date of payment by the surety.

Id. at 982.

From the cases cited by the Court in support of his holding, it appears that the Court considered the term "equitable lien" to be synonomous with "subrogation."

The opinion of the Court of Appeals, while noting that the District Court had held that the surety was subrogated to all rights of the owner, laborers and materialmen to funds due under the contract, failed to consider the effect of that legal conclusion. Instead, it focused on that portion of the District Court's opinion which found that Kentucky statute establishes a trust fund for the benefit of unpaid materialmen so that the contractor had no property in-

terest in the funds in question. The Court of Appeals held that the Kentucky statute does not create a trust fund. But regardless of whether or not there is a trust fund under Kentucky law, the surety's subrogation rights, recognized both by this Court and the courts of Kentucky, must be respected.

Consideration of these subrogation rights compels the conclusion that the contractor has no "property" or "rights to property" in the disputed funds. The surety's right of subrogation against the owner for disbursements made pursuant to its duties under the performance and payment bonds relates back in time to the date of the bonding agreement and has priority over the rights of the *contractor* or his assignee. *National Shawmut Bank v. New Amsterdam Casualty Co.*, 411 F.2d 843 (1st Cir. 1969). After the contractor's default and notice, the owner may not discharge its liability to the surety by making payment to the contractor. *American Fidelity Fire Insurance Co. v. United States*, 513 F.2d 1375 (Ct. Cl. 1975); *Fireman's Fund Insurance Co. v. United States*, 421 F.2d 706 (Ct. Cl. 1970); *Home Indemnity Co. v. United States*, 376 F.2d 890 (Ct. Cl. 1967); *National Surety Corp. v. United States*, 319 F.Supp. 45 (N.D. Ala. 1970). Indeed, at that point it has long been recognized that the contractor no longer has any property rights in the contract fund. *United States v. Commonwealth of Pa. Dept. of Highways*, 349 F.Supp. 1370, 1387 (E.D. Pa. 1972); *Atlantic Refinancing Co. v. Continental Casualty Co.*, 183 F.Supp. 478, 482 (W.D. Pa. 1960); *United States Fidelity & Guaranty Co. v. Triborough Bridge Authority*, 297 N.Y. 31, 35-36, 74 N.E.2d 226, 227-228 (1947). Therefore, any claim of the Court of Appeals that federal common law establishes a defense to an owner good against the surety when it pays over contract balances to the Internal Revenue Service directly

conflicts with the body of law that recognizes the surety's rights to recover against the owner.

Cases cited by respondents in the Court below do not diminish the surety's rights. For example, *In re Glover Construction Co., Inc.*, 30 B.R. 873 (Bankr. W.D. Ky. 1983), is not to the contrary because in that case, unlike the present one, the contractor was not in default. In fact, notwithstanding the contractor's filing of a petition under Chapter 11, the contractor continued work on both projects without interruption. *Id.* at 875. Not only was the contractor not in default at the time the Court rendered its opinion, there was no way to know whether the contractor would ever be in default. If the contractor never defaulted, then the surety would never be called upon to perform the contract or pay claims of laborers and materialmen and would, therefore, never acquire any subrogation rights in progress payments. Thus, *Glover* was distinguishable from *Pearlman* for the reason that the court was not called upon to make a retrospective determination of property rights as in *Pearlman,* but instead was asked to "formulate a *prospective* clarification of the rights of contractors and sureties to the owner's interim payments. . . ." *Id.* at 877. Furthermore, the *Glover* court recognized the surety's rights by requiring that the progress payments from the bonded jobs be applied first to pay "bona fide claims against the job" to which the surety might become liable. *Id.* at 882. In this case on the other hand, the District Court found as Finding of Fact No. 8 that Y&S defaulted in performance of the contract on or before March 4, 1970, thereby triggering the surety's subrogation rights.

The Court of Appeals also contended that under federal common law a payment made pursuant to an IRS administrative levy by a custodian of property in which the

taxpayer has an interest is a valid defense to a subsequent action by a third party claiming an interest in the property. In support of that position the Court of Appeals cited the decision of this Court in *United States v. National Bank of Commerce,* 472 U.S. ....., 86 L.Ed.2d 565, 105 S.Ct. 2919 (1985). *National Bank of Commerce,* however, did not involve a surety's subrogation rights but instead dealt with a delinquent taxpayer's rights to joint bank accounts. Furthermore, the *National Bank of Commerce* case did nothing to erode the rule that "in the application of a federal revenue act, state law controls in determining the nature of the legal interest which the taxpayer had in the property." *Id.* at ....., 86 L.Ed.2d at 575, 105 S.Ct. at ..... Nor did it involve a mistaken surrender of property to the United States.

This Court reached its decision in *National Bank of Commerce* by determining that under state law (Arkansas) the taxpayer as a joint depositor had an absolute right to withdraw all funds from the account and that such right was "property" within the meaning of U.S.C. §6331(a). But the long line of cases decided by this Court culminating in *Pearlman* makes it clear that the surety succeeds by subrogation to the owner's right to withhold or apply contract balances and, therefore, no such "absolute right" in the contractor (taxpayer) exists. Thus, the decision of the Court of Appeals does violence to the established subrogation rights of a surety in disregard of the *Pearlman* line of cases.

Since the federal tax lien does not attach to progress payments held by the owner under a construction contract where the contractor has defaulted and the performance and payment bond surety under state law is subrogated to the rights of the owner and laborers and materialmen, Internal Revenue Code §6332(d) (1967) does not relieve

Respondents from liability for honoring the tax levy. This is the necessary implication of that section and the implication is made explicit by regulation promulgated pursuant to that section which reads:

> Any person who mistakenly surrenders to the United States property or rights to property not properly subject to levy is not relieved from liability to a third party who owns the property.

Moreover, §6332(d) merely says that any person who surrenders property "shall be discharged from any obligation or liability *to the delinquent taxpayer* . . . [emphasis added]." Therefore, the statute by its own terms does not relieve Respondents of liability to petitioner.

Thus, the decision of the Court of Appeals conflicts in principle with a line of cases decided by this Court which recognize the surety's subrogation rights to contract funds and recognize that the defaulting contractor does not have "property" or "rights to property" in such funds, given the surety's rights. This conflict justifies the grant of certiorari to review the judgment below.

2. The Decision Below Conflicts With Decisions of Other Courts of Appeal As to Whether Contract Balances Subject to a Surety's Subrogation Rights Constitute Property or Rights to Property to Which the Federal Tax Lien Can Attach.

In addition to its conflict with controlling decisions of this Court, the decision below also conflicts with decisions of other Courts of Appeal. For example, in *Fidelity & Deposit Company of Maryland v. New York City Housing Authority*, 241 F.2d 142 (2d Cir. 1957), the surety for a heating and ventilating contractor which paid laborers and materialmen claimed the unpaid balance on the con-

tract in the hands of the Housing Authority. The United States claimed the funds by virtue of a tax lien for unpaid withholding taxes and an assignee for the benefit of creditors for the contractor also made claim. The Second Circuit Court of Appeals held that the government had no right to the funds as against the surety because, under New York law, the owner had the right to withhold payment to the contractor so long as there were unsatisfied claims of laborers and materialmen.

United States Fidelity & Guaranty Co. v. United States, 201 F.2d 118 (10th Cir. 1952), involved a subcontractor's Miller Act payment bond. Upon the subcontractor's default, the surety paid all unpaid claims for materials, supplies and equipment. There was still due from the contractor approximately $5,000 which both the surety and the government, by virtue of a lien for unpaid withholding taxes, claimed. The Tenth Circuit Court of Appeals held that the surety's equitable lien arising against any sum remaining in the hands of the one for whose protection the bond was written relates back to the date of the contract and is superior to a government lien for unpaid taxes subsequent to the date of the contract of suretyship. *Id.* at 121.

Central Surety & Insurance Corp. v. Martin Infante Co., 272 F.2d 231 (3d Cir. 1959), was another dispute between the United States and a surety regarding unpaid contract funds. Because the contract made the contractor's right to receive payments conditional upon submission of evidence that there were no outstanding claims against the contractor and that all its contractual obligations had been satisfied, the court held that as of the date the federal tax lien arose, the contractor was not entitled to receive any money from the contractor. Furthermore, in view of

the contractor's default it had no right to receive the balance of the contract price. The Third Circuit Court of Appeals, therefore, held that there was nothing to which the federal tax lien could attach.

Trinity Universal Insurance Co. v. United States, 382 F.2d 317 (5th Cir. 1967), was an action by a Miller Act performance bond surety for funds retained by the government to insure performance of a contract which was completed by the surety after the contractor's default. The Fifth Circuit Court of Appeals held that the completing surety, which had expended more than the full contract price, had the right to the retained funds and remaining progress payments free of the government's claimed right of setoff for unpaid federal unemployment, withholding and F.I.C.A. tax liabilities of the contractor.

These cases conflict with decision of the Circuit Court below because they recognize the surety's right of subrogation (or equitable lien) and hold that the contractor has no "property" or "rights to property" to which the federal tax lien can attach. The conflicts between these decisions justify the grant of certiorari to review the judgment below.

3. The Decision Below Raises Significant and Recurring Problems Concerning Application of the Federal Tax Lien Act.

Performance and labor and material payment bonds are utilized on virtually all major construction projects in this country. For example, the Miller Act, 40 U.S.C.A. §270a (1986), requires such bonds before any contract exceeding $25,000 in amount may be awarded for the construction, alteration or repair of any federal public

building or public work. State public construction contracts typically require the contractor to obtain such bonds, as well. While private construction is not subject to mandatory bond requirements, the utility of such bonds is so broadly recognized that they are used on almost all major private construction projects.

One of the major risks against which the performance bond is intended to secure the owner is the possibility of the contractor becoming insolvent and, consequently, unable to complete performance of the job. It is very common for an insolvent contractor to neglect to pay its federal withholding tax obligations. When that happens, a federal tax lien and levy will ordinarily follow in due course. The groundwork for a dispute such as the present one between the Internal Revenue Service and the defaulting contractor's surety has then been laid. That is why cases such as the present one present recurring problems which should be addressed by this Court. This Court recognized the importance and significance of recurring disputes such as this one by its grant of certiorari in *Pearlman v. Reliance Insurance Company*, 371 U.S. 132 (1962). Since the decision below seriously erodes the *Pearlman* doctrine, this case is an appropriate one in which to grant certiorari. Moreover, these problems are particularly significant due to the pervasive use of surety bonds in both public and private construction.

The Federal Tax Lien Act of 1966 contains a provision which establishes a special rule recognizing the validity of state law subrogation rights. Internal Revenue Code §6323(i)(2) (1967) provides that, for purposes of the federal tax lien, subrogation rights created by state law will be honored. The decision of the Court of Appeals failed to consider the effect of this provision.

The important and continuing nature of the issues raised in this case and the apparent failure of the decision below to consider the effect of applicable federal law further justifies the grant of certiorari to review the judgment below.

CONCLUSION

For these reasons, a writ of certiorari should issue to review the judgment and opinion of the Sixth Circuit.

Respectfully submitted,

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May 1, 1987

CERTIFICATE OF SERVICE

I hereby certify that on this 1st day of May, 1987, three copies of the Petition for Writ of Certiorari were mailed, postage prepaid, to THOMAS H. GLOVER, ESQ., Hays, Moss & Lynn, 267 West Short Street, Lexington, Kentucky 40507; WILLIAM GARY CRABTREE, ESQ., 120 East Fourth Street, P. O. Box 428, London, Kentucky 40741, and ELMER CUNNAGIN, JR., ESQ., Cunnagin & Cunnagin, 4th and Main Street, London, Kentucky 40741, Counsel for Respondent; ROGER M. OLSEN, ESQ., Assistant Attorney General, Department of Justice, Washington, D.C. 20530; and LOUIS DE PALAISE, ESQ., United States Attorney, Eastern District of Kentucky, Federal Building, Lexington, Kentucky 40507.

I further certify that all parties required to be served have been served.

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APPENDIX

APPENDIX A

Nos. 85-5498/5499

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

COMMONWEALTH OF KENTUCKY FOR THE BENEFIT OF UNITED PACIFIC INSURANCE COMPANY AND UNITED PACIFIC INSURANCE COMPANY,
Plaintiffs-Appellees,

v.

LAUREL COUNTY AND LAUREL COUNTY FISCAL COURT,
Defendants and Third Party Plaintiffs-Appellants.

LAUREL COUNTY BOARD OF EDUCATION,
Defendant-Appellant,

v.

UNITED STATES OF AMERICA,
Third Party Defendant-Appellee.

ON APPEAL from the United States District Court for the Eastern District of Kentucky.

Decided and Filed November 14, 1986

Before: LIVELY, Chief Judge; and WELLFORD and BOGGS, Circuit Judges.

WELLFORD, Circuit Judge. Defendants Laurel County, Laurel County Fiscal Court, and Laurel County Board of Education (collectively, the "county agencies") appeal from an order of the district court granting plaintiff United Pacific Insurance Company (United Pacific), a performance and payment bond surety on a public construction project, summary judgment on its claim for funds payable under the construction contract. Defendant Laurel County Fiscal Court paid these funds over to the Internal Revenue Service (IRS) by virtue of a levy for unpaid taxes of the contractor Y & S Construction Company (Y & S). Defendants also appeal from an order of the district court dismissing their third-party complaint against the United States.

This damage action was brought in 1974 by United Pacific against the county agencies, the Laurel County Treasurer, and others with respect to a construction contract between Y & S and the county agencies for the construction of the Laurel County High School building at London, Kentucky. On July 28, 1975, the county agencies filed a third-party complaint against the United States. That claim was dismissed by the district court (Judge Moynahan) in a memorandum opinion entered on March 18, 1976. Thereafter, on January 16, 1985, the district court (Judge Bertelsman) entered findings of fact, conclusions of law, and a judgment, granting summary judgment in favor of United Pacific in the total amount of $197,728.39, including interest to November 8, 1984. On May 1, 1985, the district court filed an amended judgment adopting additional findings of fact and conclusions of law. The county agencies now appeal.

I.

Y & S contracted with the Laurel County Fiscal Court and the Laurel County Board of Education in 1969 for the construction of the school. At the time the construction contract was signed, Y & S, as principal, and the plaintiff, United Pacific, as surety, executed and delivered a performance bond in the amount of the contract price, $2,524,250, as well as a labor and material payment bond in the same amount.

On February 4, 1970, the IRS filed a notice of tax lien against taxpayer Y & S in the amount of $185,031.05. On March 11, 1970, a second and separate notice of tax lien was filed in the amount of $162,718.64.[1] Y & S apparently failed to submit withholding taxes for its employees for July through December 1969. On or before March 4, 1970, Y & S defaulted in the performance of the construction contract when it was about 75 percent completed. United Pacific sent a letter to Leon Browning, the architect and owner's representative, requesting that no further contract funds be paid to the contractor or anyone else without its written consent. On March 15, 1970, Y & S sent letters to the Laurel County Fiscal Court and to Browning requesting that all funds due or about to be due on the contract be paid to United Pacific. The notice to the Fiscal Court was signed and returned by the County Treasurer, and the notice to Browning was signed and returned by him.

On April 17, 1970, Browning certified that $116,666.59 was due and payable to taxpayer Y & S. On or about May 15, 1970, United Pacific made demand on the Laurel

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1. The district court made no findings of facts with respect to these filing dates and amounts. Counsel for the government supplies this information in his brief.

County Fiscal Court for all sums coming due under the contract. The government's brief notes that on or about May 18, 1970, a notice of levy was served on the Laurel County Fiscal Court for taxes due and owing by Y & S in the amount of $100,833.91.

On May 18, 1970, when visited by an IRS Revenue Officer with this tax levy,[2] the Laurel County Fiscal Court paid the sum of $100,833.91 to the IRS out of the School Construction Project Fund by a check endorsed by George Cloyd, Laurel County Treasurer. Prior to paying over the funds, Cloyd consulted two local attorneys, who advised that there might be personal liability if the IRS levy were not honored. Cloyd had earlier been authorized by resolution and order of the Laurel County Fiscal Court to make disbursements out of the School Construction Project Fund upon certification by Browning that the said funds were due and owing.

The Laurel County Treasurer advised United Pacific of the payment to the IRS in a letter dated May 18, 1970, and United Pacific duly and promptly protested the same. Ultimately, of the contract price of $2,554,532.15, $1,587,995.03 was in fact paid Y & S, $865,703.21 was paid to the surety, which completed the contract after Y & S's default, and $100,833.91 was paid to the IRS.

United Pacific seeks damages by a breach of contract action for the amount paid to the IRS (i.e., $100,833.91). The defendants joined the United States as a third-party

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2. In their joint pretrial order, the parties stipulated the fact of the May 18, 1970, IRS levy "(s)ubject to production of levy." The defendants failed to produce a copy of the levy, although they were ordered to do so on two separate occasions by the district court. A copy of a blank "notice of levy" form ordinarily used by the IRS during this period was filed as a part of the record. We therefore face the anomaly of deciding the effect of a purported levy that is not a part of the record.

defendant on July 28, 1975. In dismissing the claim against the United States, the district court held that the defendants had not complied with the nine-month limitations period of bringing actions for alleged wrongful tax levies.

The district court later found that as a matter of state law "the funds due under the contract had not become the property of the taxpayer" because "[t]he Kentucky statutory provision, KRS 376.070, establishes a trust fund for the benefit of unpaid materialmen, and as such the funds due under the contract were not and never became the property of the taxpayer." In so ruling, the court noted that Section 6332(d) of the Internal Revenue Code does not relieve a person mistakenly or erroneously making payment to the IRS pursuant to a tax levy from liability to the true owner of the funds. Accordingly, judgment against defendants was entered on January 16, 1985, in the sum of $197,728.39, including interest.

II.

In ruling on the motion of plaintiff United Pacific for summary judgment, Judge Bertelsman wrote in his January 16, 1985, conclusions of law:

> 4. This Court must look to state law to control the determination of the nature of the legal interest of the taxpayer in the property (funds due under the contract). Whether this property interest under state law constitutes "property or rights to property" subject to levy is strictly a matter of federal law. *Aquilino v. United States*, 363 U.S. 509, 80 S. Ct. 1277, 4 L.Ed.2d 1365 (1960); *United States v. Lebanon Woolen Mills Corp.*, 241 F. Supp. 393 (1964); *City of New York v. United States*, 283 F.2d 829 (1960).

5. That upon default by the taxpayer, Y & S Construction Company, the funds due under the contract had not become the property of the taxpayer under state law. KRS 376.070(1); *In re D & B Elec., Inc.*, 4 B.R. 263 (W.D. Ky. 1980); *Blanton v. Commonwealth, Ky.*, 562 S.W.2d 90 (1978).

6. The Kentucky statutory provisions, KRS 376.070, establishes a trust fund for the benefit of unpaid materialmen, and as such the funds due under the contract were not and never became the property of the taxpayer.

7. Under federal law, the taxpayer, Y & S Construction Company, had no property interest under state law constituting "property or rights to property" subject to levy. *United States v. Durham Lumber Co.*, 363 U.S. 522, 4 L.Ed.2d 1371, 80 S. Ct. 1282 (1958).

8. The rights of the Plaintiff, United Pacific Insurance Company, accrued as of the time of the execution of the bonds. Upon satisfying the materialmen and laborers, the Plaintiff surety became subrogated to all rights of the owner, laborers and materialmen to funds due under the contract. [Citations omitted].

Thus, the district court concluded that the IRS tax lien did not properly attach to the right of Y & S to receive payments under the construction contract and that the payment honoring the IRS levy on its lien by the county agencies was wrongful. *See* 26 U.S.C. §§ 6321, 6332.

We note with concern the extreme delays, attributable to the handling of this case by the district judge originally assigned, and the inadequate record developed concerning the levy in this case. This litigation concerns events

which occurred in early 1970; the initial complaint in this case was filed in 1974; and the final judgment below, disposing of this case on motions for summary judgment, was not entered until 1985.[3] Moreover, our resolution of the issues here is made more difficult by the failure of the parties to offer into evidence the notice of levy allegedly served on May 18, 1970.[4] Although the affidavit of the county treasurer, the responsible county officer who apparently received the IRS demand for payment and issued a check to the IRS, states that a "lawful levy" was made on May 18, 1970, for the progress payment at issue, the county treasurer's deposition is less than a model of clarity concerning the fact of the serving of the notice of levy. (By the time of the county treasurer's 1982 deposition, he was 87 years old, and by 1984 the other three individuals with personal knowledge of the levy—the two attorneys consulted by the treasurer and the IRS agent involved—were all deceased.) For its part, the district court found that, "[a]s evidenced by the tax levy form stipulated into evidence, the actual levy, if any, was a general levy upon all property or rights to property belonging to the taxpayer, Y & S Construction Company." Its conclusions, however, rendered any further factual findings concerning the levy immaterial.

The Internal Revenue Code gives the United States a lien upon "all property and rights to property, whether real or personal," belonging to a delinquent taxpayer. 26 U.S.C. § 6321. The Code further provides that, after notice and demand to a delinquent taxpayer, the Secretary may collect such tax by levy upon "all property and

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3. This case was not assigned to Judge Bertelsman until May 1983, and he promptly reached disposition.

4. *See supra* note 2.

rights to property . . . belonging to such person or on which there is a lien provided in this chapter for the payment of such tax." 26 U.S.C. § 6331(a). The term "levy" includes "the power of distraint and seizure by any means." 26 U.S.C. § 6331(b). Treasury regulations provide that such a seizure may be made by serving a notice of levy. 26 C.F.R. § 301.6331-1(a)(1). Section 6332(a) provides for such a levy upon a custodian of the delinquent taxpayer's property. 26 U.S.C. §6332(a). *See United States v. National Bank of Commerce,* 105 S.Ct. 2919, 2924-25 (1985). Thus, the threshold question in this case is whether the interest of the taxpayer, Y & S, in the progress payment partially surrendered to the IRS constituted property or rights to property under 26 U.S.C. § 6321. The plaintiff surety does not, and in our view could not, argue that the levy in this case was improper or unlawful if taxpayer Y & S had any interest in the progress payment to which the tax lien could have attached. *See United States v. National Bank of Commerce, supra.*

As the district court concluded, state law controls whether the taxpayer, Y & S, had a property interest in the progress payment, but once a property interest is found federal law determines the consequences flowing from the levy. *Compare Aquilino v. United States,* 363 U.S. 509 (1960) (remanding to New York Court of Appeals for determination of whether state law created trust for the benefit of subcontractors, divesting contractor-taxpayer of any beneficial interest), *with United States v. Durham Lumber Co.,* 363 U.S. 522 (1960) (decided same day as *Aquilino;* affirming Fourth Circuit holding that tax lien did not attach to interest of contractor-taxpayer in amounts owed under construction contract where state law

provided trust for the benefit of subcontractors). *See also* Note, *Property Subject to Federal Tax Lien,* 77 Harv. L. Rev. 1485 (1964). The district court relied on a Kentucky statute and two cases construing Kentucky law to find that Y & S had no property interest. *See* Ky. Rev. Stat. § 376.070 (1972); *In re D & B Electric, Inc.,* 4 Bankr. 263 (Bankr. W.D. Ky. 1980); *Blanton v. Commonwealth,* 562 S.W.2d 90 (Ky. App. 1978).

The Kentucky statute relied upon by the district court imposes an obligation on a contractor to apply payments from the owner to claims of those who have furnished labor or materials to the project:

> **376.070. Contractor or architect to apply payments to claims—Exception where lien waived.—** (1) Any contractor, architect or other person who builds, repairs or improves the property of another under such circumstances that a mechanics' or materialman's lien may be imposed on the property shall, from the proceeds of any payment received from the owner, pay in full all persons who have furnished material or performed labor on the property.
>
> (2) If any payment by the owner to the contractor, architect or other person is not sufficient to pay in full all bills for material and labor, then such claims shall be paid on a pro rata basis to the amount of payments received, unless otherwise agreed between the contractor, architect or other person and the holder of the claim for material or labor.
>
> (3) This section shall not apply where persons furnishing material or performing labor have waived in writing their right to file mechanics' or materialmen's liens.

Ky. Rev. Stat. § 376.070 (1972).[5] This statute is found in the chapter relating to "Statutory Liens" and is both preceded and followed by provisions for mechanics' and materialmen's liens. *See* Ky. Rev Stat. §§ 376.010 (creating mechanics' and materialmen's liens; filing required), 376.090(1) (12-mo. period of limitation), 376.990(2) ($50-1000 fine or 1-12 mos. imprisonment, or both, for violation of 376.070).

In *Blanton v. Commonwealth,* 562 S.W.2d 90, 91-93 (Ky. App. 1978), Kentucky's intermediate appellate court held that Ky. Rev. Stat. § 376.070 imposed upon an individual building contractor a "known legal obligation" (i.e., to pay in full all claims for material and labor involving a particular job out of the payments received from the owner) sufficient to support a felony criminal conviction under Ky. Rev. Stat. § 514.070(1) for theft by failure to make a required disposition of property. The opinion neither discusses nor rests upon any argument that § 376.070 creates a trust by implication.

In the principal case relied upon by the district court, a bankruptcy court interpreted § 376.070 as creating a trust fund by implication in order to resolve competing claims of a materialman and the trustee in bankruptcy. *In re D & B Electric, Inc.,* 4 Bankr. 263 (Bankr. W.D. Ky. 1980). The bankruptcy trustee claimed a superior right under § 70c of the Bankruptcy Act to two checks held by a materialman and jointly payable to the materialman and the bankrupt, the subcontractor on the project. The ma-

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5. The defendants argue that Ky. Rev. Stat. § 376.070 is inapplicable to public construction projects because of the separate statutory scheme for mechanics' and materialmen's liens on public projects. *See* Ky. Rev. Stat. §§ 376.195-376.260. One Kentucky case, however, seems to foreclose this argument by expressly relying in part upon § 376.070 in a public construction contract case. *See Petter Supply Co. v. Hal Perry Construction,* 563 S.W.2d 749, 750, 751 (Ky. App. 1978).

terialman supplied lighting fixtures for two projects on which the bankrupt was the electrical subcontractor, and the bankrupt fell into arrears in its accounts with the materialman. The materialman failed to file, as was its statutory right, a lien against the materials furnished. After the period within which the materialman could have filed its lien, it entered into two settlement agreements with the general contractors on the projects, who each issued a check payable jointly to the materialman and the bankrupt for the unpaid amounts. On these facts, the bankruptcy court held:

> Despite its inability to claim title as an equitable lienholder superior to that of the trustee, Rueff's position as an unpaid materialman causes the *creation of a trust for its benefit* of funds in the hands of the general contractors, thereby bypassing D & B's [the bankrupt's] estate entirely. In effect, the funds are not, nor will they ever become, D & B's property, and the trustee can therefore lay no claim on them.

Id. at 268 (original emphasis).

In reaching this holding, the bankruptcy court relied upon *Selby v. Ford Motor Co.*, 590 F.2d 642 (6th Cir. 1979), and *Parker v. Klochko Equipment Rental Co., Inc.*, 590 F.2d 649 (6th Cir.), *cert. denied*, 444 U.S. 831 (1979), cases imposing a trust fund on payments to the contractor in favor of materialmen under *Michigan* law, 4 Bankr. at 268-69. As the bankruptcy court noted, however, the Michigan statute *Selby* and *Parker* relied upon expressly creates such a trust fund,[6] *id.* at 268, while the Kentucky

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6. The statute provides:

> In the building construction industry, the building contract fund paid by any person to a contractor, or by such

(Continued on following page)

statute, "[u]nlike the Michigan Builder's Trust Fund Act, . . . does not expressly establish a trust fund for the benefit of unpaid materialmen." *Id.* at 269. The bankruptcy court reasoned:

> However, such construction should be implied from the forceful wording of the act (coupled with criminal penalties for non-compliance), as well as the strong public policy preference of trust fund theory enunciated in *Selby*.

Id. (footnote omitted). The court further relied on *Petter Supply Co. v. Hal Perry Construction*, 563 S.W.2d 749, 751 (Ky. App. 1978), which held that a materialman was a third party beneficiary to a contract providing for payment and that Ky. Rev. Stat. § 367.070 [sic] imposed a duty on the contractor regardless of the lapse of the materialman's lien rights. The opinion in *Petter* neither discusses nor rests upon any argument that § 376.070 creates a trust by implication.

The district court's reliance on *D & B Electric* is misplaced, and the opinion in *D & B Electric* itself is fundamentally flawed. The holding of *D & B Electric* has been very narrowly construed by other subsequent bankruptcy court decisions construing § 376.070 (including two by the

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Footnote continued—

> person or contractor to a subcontractor, *shall be considered by this act to be a trust fund,* for the benefit of the person making the payment, contractors, laborers, subcontractors or materialmen, and *the contractor or subcontractor shall be considered the trustee of all funds so paid to him* for building construction purposes.

Mich. Comp. Laws § 570.151, Mich. Stat. Ann. § 26.331 (emphasis added). The next following code section criminalizes fraudulent detention or use of such funds. Mich. Comp. Laws § 570.152, Mich. Stat. Ann. § 26.332.

judge who wrote *D & B Electric*[7]) and its reasoning has been rejected by other courts. In addition to the subsequent decisions narrowly construing *D & B Electric* and questioning its effect, other courts have declined to adopt the rationale of *D & B Electric* in interpreting § 376.070. *See In re The Dave Thomas Co., Inc.*, 51 Bankr. 66 (Bankr. W.D. Ky. 1985); *In re Allgeier & Dyer*,[8] 18 Bankr. 82 (Bankr. W.D. Ky. 1982). Finally, several well reasoned opinions facing similar questions under the laws of other states have expressly declined to follow *D & B Electric*. *See Georgia Pacific Corp. v. Sigma Service Corp.*, 712 F.2d 962, 967-72 (5th Cir. 1983); *In re Georgia Steel, Inc.*, 56 Bankr. 509, 516-17 (Bankr. M.D. Ga. 1985).

We therefore find that the district court in this case erred in relying upon *D & B Electric* and *Blanton*, and we conclude that taxpayer Y & S indeed possessed "property" or "rights to property" under Kentucky law in the progress payments at issue. Because, however, we cannot be certain concerning the existence of the IRS levy, we are compelled to remand for a finding on this critical factual issue. The district court made no specific factual finding as to the existence, date, or service of the critical levy.

III.

The district court also ruled that federal law did not protect the county agencies from liability for wrongful payment pursuant to an IRS administrative levy:

> Section 6332(d) of the Internal Revenue Code of 1954 does not relieve a person mistakenly or erroneously

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7. *See In re Glover Construction Co., Inc.*, 30 Bankr. 873 (Bankr. W.D. Ky. 1983); *In re Jeanes Mechanical Contractors, Inc.*, 32 Bankr. 657 (Bankr. W.D. Ky. 1983).

8. *In re LaFollette Sheet Metal, Inc.*, 35 Bankr. 634 (Bankr. E.D. Tenn. 1983) neither rejected nor adopted *D & B Electric*, stating: "[I]t is not necessary for this court to decide whether to follow the holding of *D & B Electric* . . . ." 35 Bankr. at 638.

> making payment to the Internal Revenue Service pursuant to a tax levy of liability to the true owner of the funds. The Defendants, Laurel County, Laurel County Fiscal Court and the Laurel County Board of Education, are not entitled to take credit for the amount paid to the Internal Revenue Service against the amount due under the contract to the Plaintiff, United Pacific Insurance Company.

In its amended judgment, the district court further concluded that

> plaintiff is under no legal obligation to the defendants to pursue the remedy contained in 26 U.S.C. § 7426 (a)(1) in order to recover the funds wrongfully paid to the IRS. Lastly, plaintiffs' failure to bring suit under 26 U.S.C. § 7426(a)(1) operates neither as an election of remedies, *Collings v. Scheen*, 415 S.W.2d 589, 591 (Ky. 1967), nor a waiver of its contractual rights against defendants.

The county agencies and the government as amicus curiae forcefully argue that the district court's ruling conflicts with established federal case law. We agree.

The district court correctly held that 26 U.S.C. § 6332 (d) does not provide the county agencies a defense; the district court overlooked, however, the common law that existed well before § 6332(d) was enacted as a part of the Federal Tax Lien Act of 1966, Pub. L. No. 89-719, § 104 (b)(4), 80 Stat. 1135 (1966). The county agencies and the county treasurer were required, at the risk of liability imposed directly on them (which could have included the principal amount due, costs, interest, and stiff penalties), to honor the levy. *See* 26 U.S.C. § 6322(c). The courts have held that a person served with a notice of levy has only two possible defenses for failure to comply with the

demand: (1) that he is not in possession of the taxpayer's property or property in which the taxpayer has any interest, and (2) that the property is subject to a prior judicial attachment or execution. *United States v. National Bank of Commerce,* 105 S. Ct. 2919, 2925 (1985). The fact that other parties may have competing claims to the property is not one of these defenses. *See, e.g., Determan v. Jenkins,* 111 F. Supp. 604, 605 (N.D. Ga. 1953).

Prior to the enactment of § 6332(d), the Internal Revenue Code was silent as to the consequences of a debtor of a taxpayer honoring an IRS levy. Section 6332 (d) provides that any person honoring a federal tax levy by surrendering property subject to levy "shall be discharged from any obligation or liability *to the delinquent taxpayer* with respect to such property or rights to property arising from such surrender or payment." 26 U.S.C. § 6332(d) (emphasis added). Section 6332(d) discharges a custodian from liability to the taxpayer but is silent as to third parties.[9] We believe that the silence of § 6332(d)

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9. The Treasury regulation relied upon by the surety, 26 C.F.R. § 301.6332-1(c) (1985), is also inapposite. The regulation provides:

> Any person who mistakenly surrenders to the United States properly [sic] or rights to property not properly subject to levy is not relieved from liability to a third party who owns the property. The owners of mistakenly surrendered property may, however, secure from the United States the administrative relief provided for in section 6343(b) or may bring suit to recover the property under section 7426.

In our view, the regulation correctly states the effect of § 6332(d) on liability to third parties: the statute does not relieve custodians of such liability. We do not interpret the statute or the regulation, however, to impose such liability. Neither does it purport to reject case law providing a defense to such liability.

There is no evidence here that the county agencies "mistakenly" honored the levy here. If there was a levy, the county agencies made no mistake in honoring a lawful levy. If no levy is proven on remand, the case law discussed below provides the county agencies no defense.

strongly suggests congressional intent not to disturb existing case law concerning the potential liability of custodians to third parties.

The case law clearly holds that a payment made by a custodian of property in which the taxpayer has an interest pursuant to an IRS administrative levy is a valid defense to a subsequent action by a third party claiming an interest in the property. The cases cited by the government, although few, do support this proposition. *See Determan v. Jenkins,* 111 F. Supp. 604 (N.D. Ga. 1953); *Sebel v. Lytton Savings and Loan Association,* 65-1 U.S. Tax Cas. (CCH) ¶ 9343 (S.D. Cal. 1965); *Bolling v. Samples,* 117 Ga. App. 38, 159 S.E.2d 727 (1967); *DiEdwardo v. First National Bank of Bath,* 442 F. Supp. 499 (E.D. Pa. 1977); *see also United States v. National Bank of Commerce,* 105 S. Ct. 2919 (1985).

Determan, DiEdwardo, Sebel, and *Bolling* all hold custodians harmless to claims of third parties, even where the payment may have been wrongful, citing the remedies expressly available to third parties, under the tax code, *see* 26 U.S.C. § 7426(a)(1), and the administrative needs of the federal tax system. In *United States v. National Bank of Commerce* the Court held that a bank could not lawfully refuse to honor a levy on a joint account on the ground that the possibility existed that the bank would be liable to nontaxpayer third parties having an interest in the account. The Court relied heavily on the fact that the law provides a remedy for third parties adversely affected by a levy. 105 S. Ct. at 2928-29, 2930.

We thus hold that where, as alleged here, the custodian of a taxpayer's property or rights to property has at the time of levy no defense for failure to comply

with the levy (i.e., the custodian cannot claim that it is neither "in possession of" nor "obligated with respect to" property of the taxpayer or that the taxpayer's property is subject to a prior judicial attachment or execution, *see United States v. National Bank of Commerce,* 105 S. Ct. at 2925,) and thus honors a lawful IRS levy, the custodian has a valid and complete defense under federal law to claims of third parties with interests in the property surrendered.[10] Therefore, if on remand an IRS levy is proven, the county agencies would be entitled to this defense under federal law; if, however, an IRS levy is not proven, this defense would not be available. Because we cannot be certain that the IRS levy alleged will be proven on remand, we are compelled to address the remaining issue presented by the county agencies on appeal.[11]

IV.

The county agencies argue that the district court erred in dismissing their third-party complaint against the United States.

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10. Because the facts of this case do not present the issue, we do not decide whether federal law provides the custodian a defense to claims of third parties where the custodian may have had defenses to a lawful IRS levy.

11. Defendants argue that they are immune from suit in this matter under the state constitutional law doctrine of sovereign immunity and under state common law. Because these issues were neither addressed nor relied on by the district court in its decision, we do not reach them.

Although defendant Laurel County Board of Education addresses the issue in its brief, the defendants Laurel County and Laurel County Fiscal Court do not in their brief and did not at oral argument contend that the district court erred in granting the motion of the Board of Education for summary judgment on its cross-claim against the County and the Fiscal Court for indemnity. We treat any claim of error on this issue to be waived.

On March 19, 1976, the district court dismissed the county agencies' third-party complaint as untimely. The county agencies asserted in their third-party complaint that, if they were found to be liable to the plaintiff surety for the amount paid to the IRS, then the United States should be held liable to the county agencies in the same amount. Noting that "under the doctrine of sovereign immunity the United States cannot be sued absent legislative enactment specifically waiving sovereign immunity," the district court found only one applicable statutory provision, 26 U.S.C. § 7426. The district court held that under the appropriate statute of limitations, *see* 26 U.S.C. § 6532(c) (9-mo. period of limitation), and any applicable exceptions, *see* 26 U.S.C. § 6532(c)(2) (12-mo. period of limitation conditioned on filing of request for return of property), the county agencies' third-party complaint, filed more than five years after the events at issue, was untimely.

The county agencies' principal argument on appeal is that the district court should have treated their third-party complaint as an action for interpleader under 28 U.S.C. § 2410(a)(5). The county agencies' argument is without merit, however, because, having honored the levy, they could not maintain an interpleader action under § 2410(a)(5) as they were not stakeholders in possession of property subject to conflicting claims. *See Johnson Service Co. v. H. S. Kaiser Co.*, 324 F. Supp. 745, 749-50 (N.D. Ill. 1971); *South Brooklyn Savings Bank v. All State Insurance Co.*, 84 Misc.2d 287, 375 N.Y.S.2d 273 (N.Y. Sup. Ct. 1975).

The reasoning of the district court is, moreover, entirely sound. The only arguably applicable provision available to the county agencies as a basis for their claim was

26 U.S.C. § 7426.[12] The appropriate statute of limitations, 26 U.S.C. § 6532(c), provides that a wrongful levy suit must be commenced within nine months of the date of levy or, if an administrative request for the return of the property is filed within the nine-month period, the suit must be commenced within twelve months of the filing of the request. Thus, as the district court correctly concluded, a wrongful levy suit must be filed, at the latest, within twenty-one months of the levy. The county agencies' third-party complaint is, therefore, time-barred as it was filed more than five years after the levy in question.

The judgment of the district court is accordingly AFFIRMED in part, REVERSED in part, and REMANDED for further proceedings consistent with this opinion.

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12. Indeed, the response filed by the county agencies to the motion of the United States to dismiss the third-party complaint relies solely upon 28 U.S.C. § 2410 and 26 U.S.C. § 7426 as the statutory waivers of sovereign immunity allegedly applicable on these facts.

APPENDIX B

(Filed February 4, 1987)

NOS. 85-5498/5499

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

COMMONWEALTH OF KENTUCKY FOR THE BENEFIT OF UNITED PACIFIC INSURANCE COMPANY AND UNITED PACIFIC INSURANCE COMPANY,
Plaintiffs-Appellees,

v.

LAUREL COUNTY AND LAUREL COUNTY FISCAL COURT,
Defendants and Third Party Plaintiffs-Appellants,

LAUREL COUNTY BOARD OF EDUCATION,
Defendant-Appellant,

v.

UNITED STATES OF AMERICA,
Third Party Defendant-Appellee.

ORDER OF AMENDMENT

BEFORE: LIVELY, Chief Judge; and WELLFORD and BOGGS, Circuit Judges.

The decision filed in these cases on November 14, 1986, is amended by adding the following to the first full paragraph on page 19 (page 17, slip opinion):

Nor is a Rule 22 interpleader proceeding against the United States an available remedy to Laurel County in this case. An interpleader proceeding does not establish jurisdiction: "The United States may not be required to interplead when it has not waived its sovereign immunity." 7 C. Wright, A. Miller, & M. Kane, *Federal Practice and Procedure* § 1721, at 654 (2d ed. 1986) (citing, *inter alia, United States v. Dry Dock Savings Institution,* 149 F.2d 917 (2d Cir. 1945)). There has been here no waiver of sovereign immunity with respect to the Laurel County claim. Section 2410 (a) (5), moreover, by its express language applies only to controversies over property "on which the United States has or claims a mortgage or other lien." This is simply not such a dispute. There is no claim for mortgage or other lien; rather, a tax levy[12] is involved.

(Footnote 12 on page 19 [page 17 of slip opinion] becomes footnote 13).

ENTERED BY ORDER OF THE COURT

/s/ John P. Hehman
CLERK

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12. "Levy" and "lien" are not synonomous. *See* Black's Law Dictionary at 816, 832 (5th ed. 1979). "Levy" is a form of "seizure." *See* 53 C.J.S. "Levy" at 2 (1948); *see also* 84 C.J.S. *Taxation* § 349 (1954).

APPENDIX C

(Filed January 16, 1985)

NO. 74-293

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF KENTUCKY
AT LONDON

COMMONWEALTH OF KENTUCKY, FOR THE BENEFIT OF UNITED PACIFIC INSURANCE COMPANY, AND UNITED PACIFIC INSURANCE COMPANY
PLAINTIFFS

VS.

LAUREL COUNTY, LAUREL COUNTY FISCAL COURT, et al
DEFENDANTS

FINDINGS OF FACT, CONCLUSIONS OF LAW AND JUDGMENT

The within action having come on for hearing before the Court on Thursday, November 8, 1984, with respect to all pending motions; the Court having considered the pleadings and memoranda submitted by the parties, having heard argument of counsel, and being otherwise sufficiently advised, the Court herewith enters its Findings of Fact, Conclusions of Law, and Judgment.

FINDINGS OF FACT

1. The Plaintiff, United Pacific Insurance Company, is a citizen of the United States, and is duly incorporated under the laws of the State of Washington. Said Plaintiff

is a citizen only of the State of Washington for purposes of diversity under 28 USC §1332, by virtue of the fact that it is incorporated only in the State of Washington and has its principal place of business at Tacoma, Washington.

2. The Defendants, Laurel County, Laurel County Fiscal Court, Laurel County Board of Education, and all individually named Defendants, are citizens only of the State of Kentucky for purposes of diversity under 28 USC §1332.

3. The amount in controversy in this action exceeds the amount of $10,000.00, exclusive of interest and costs.

4. On March 7, 1969, the Y & S Construction Company, Inc., entered into a contract for the construction of the Laurel County High School Building at London, Kentucky. A copy of said contract has been filed herein as Plaintiffs' Exhibit 4.

5. The immediately hereinabove referenced contract specified the Laurel County Fiscal Court as "Owner" in the caption thereof, and was executed by John V. Gross, County Judge, for and on behalf of the Laurel County Fiscal Court as Owner, and was executed by Otis Peters, Chairman, for and on behalf of the Laurel County Board of Education, also as Owner.

6. Contemporaneously with the execution of the contract on March 7, 1969, the Y & S Construction Company, Inc., as principal, and the Plaintiff, United Pacific Insurance Company, as surety, executed and delivered a Performance Bond in the amount of $2,524,250.00. Further, there was on said date, executed and delivered by Y & S Construction Company, Inc., as principal, and the Plaintiff, United Pacific Insurance Company, as surety, a Labor and Material Payment Bond in the amount of $2,524,250.00.

Said bonds have been filed herein as Plaintiffs' Exhibits 5 and 6, respectively.

7. That as of the date of the execution of the referenced contract and as of the date of the filing of the complaint in this action, George Cloyd was the County Treasurer of Laurel County.

8. On or before March 4, 1970, Y & S Construction Company defaulted in the performance of its contract to construct the Laurel County High School Building under the terms of the herein referenced contract.

9. On or about March 4, 1970, the United Pacific Insurance Company sent to Leon E. Browning, Architect and Owners Representative, by certified mail, the notice letter filed herein as Plaintiffs' Exhibit 8.

10. On or about March 15, 1970, Y & S Construction Company sent to the Laurel County Fiscal Court its directive as to disbursement of funds due under the contract, which letter was endorsed to United Pacific Insurance Company by George W. Cloyd, Laurel County Treasurer. Said letter has been filed herein as Plaintiffs' Exhibit 9.

11. On or about March 15, 1970, Y & S Construction Company sent to Leon E. Browning, Architect and Owners Representative, its directive as to disbursement of funds due under the contract, which letter was endorsed to United Pacific Insurance Company by Leon E. Browning. A copy of said letter has been filed herein as Plaintiffs' Exhibit 10.

12. On April 17, 1970, Leon E. Browning, Architect and Owners Representative, certified that $116,666.59 was due and payable to the contractor. Said Certificate of Payment No. 13 has been filed herein as Plaintiffs' Exhibit 14.

13. On or about May 15, 1970, United Pacific Insurance Company made demand of the Laurel County Fiscal Court for all sums which became payable under the herein referenced contract. A copy of the telegram demanding said payment has been filed herein as Plaintiffs' Exhibit 15.

14. As evidenced by the tax levy form stipulated into evidence, the actual levy, if any, was a general levy upon all property or rights to property belonging to the taxpayer, Y & S Construction Company.

15. On May 18, 1970, the Laurel County Fiscal Court paid the sum of $100,833.91 to the Internal Revenue Service out of the School Construction Project Fund by check endorsed by George Cloyd, Laurel County Treasurer.

16. George W. Cloyd, Laurel County Treasurer, was authorized by resolution and order of the Laurel County Fiscal Court to make disbursements out of the School Construction Project Fund upon certification by Leon E. Browning, Architect and Owners Representative, that said funds were due and owing.

17. The amended contract price for construction of the High School Building was $2,554,532.15. The sum of $1,587,995.03 was paid directly to the principal, Y & S Construction Company. The sum of $865,703.21 was paid directly to the surety, United Pacific Insurance Company. The sum of $100,833.91 was paid to the Internal Revenue Service and claimed as a credit by the Defendants. Said amounts were stipulated by the parties in the pre-trial memorandum filed herein.

18. The Plaintiff, United Pacific Insurance Company, expended sums in excess of $100,833.91 over and above the remaining sum of $865,703.21 due under the contract,

in fulfilling its obligation under the Performance Bond and in fulfilling its obligation under the Payment Bond as evidenced by the uncontroverted affidavit of Richard Bush, Jr. filed herein on March 27, 1984.

19. The parties have stipulated that subsequent to the default by Y & S Construction Company in the performance of the herein referenced contract, the Plaintiff, United Pacific Insurance Company, completed construction of the High School Building as required by the contract.

20. The Defendant, Laurel County, by and through its Fiscal Court, was in control of the School Construction Project Funds at all relevant times.

21. The actual cost of constructing the high school building did not exceed the proceeds from the sale of the revenue bonds issued to finance construction of the project, as evidenced by the affidavit of Joe McKnight dated October 27, 1983.

CONCLUSIONS OF LAW

1. All parties are properly before the court, and this Court has jurisdiction of the matter by virtue of diversity of citizenship under 28 USC §1332.

2. The contract between the parties dated May 7, 1969 and filed herein as Plaintiffs' Exhibit 5 is a good and valid contract, binding on the parties according to its terms.

3. In considering the motion of the Plaintiff, United Pacific Insurance Company, for summary judgment, the facts must be construed in the light most favorable to the Defendants.

4. This Court must look to state law to control the determination of the nature of the legal interest of the

taxpayer in the property (funds due under the contract). Whether this property interest under state law constitutes "property or rights to property" subject to levy is strictly a matter of federal law. *Aquilino v. United States,* 363 U.S. 509, 80 S. Ct. 1277, 4 L.Ed.2d 1365 (1960); *United States v. Lebanon Woolen Mills Corp.,* 241 F.Supp. 393 (1964); *City of New York v. United States,* 283 Fed. 2d 829 (1960).

5. That upon default by the taxpayer, Y & S Construction Company, the funds due under the contract had not become the property of the taxpayer under state law. KRS 376.070(1); *In re D & B Elec., Inc.,* 4 B.R. 263 (W.D. Ky. 1980); *Blanton v. Commonwealth,* Ky., 562 S.W.2d 90 (1978).

6. The Kentucky statutory provision, KRS 376.070, establishes a trust fund for the benefit of unpaid materialmen, and as such the funds due under the contract were not and never became the property of the taxpayer.

7. Under federal law, the taxpayer, Y & S Construction Company, had no property interest under state law constituting "property or rights to property" subject to levy. *United States v. Durham Lumber Co.,* 363 U.S. 522, 4 L.Ed.2d 1371, 80 S.Ct. 1282 (1958).

8. The rights of the Plaintiff, United Pacific Insurance Company, accrued as of the time of the execution of the bonds. Upon satisfying the materialmen and laborers, the Plaintiff surety became subrogated to all rights of the owner, laborers and materialmen to funds due under the contract. *Pearlman v. Reliance Insurance Co.,* 371 U.S. 132, 9 L.Ed. 2d 190, 83 S.Ct. 232 (1962); *Prairie State National Bank v. United States,* 164 U.S. 227, 41 L.Ed. 412, 17 S.Ct. 142 (1896); *Henningsen v. United States*

Fidelity and Guaranty Co., 208 U.S. 404, 52 L.Ed. 547, 28 S.Ct. 389 (1908); *United States v. Munsey Trust Co.*, 332 U.S. 234, 91 L.Ed. 2022, 67 S.Ct. 1599 (1947), and *National Su. Corp. v. State National Bank of Frankfort*, Ky., 454 S.W.2d 354 (1970).

9. Section 6332(d) of the Internal Revenue Code of 1954 does not relieve a person mistakenly or erroneously making payment to the Internal Revenue Service pursuant to a tax levy of liability to the true owner of the funds. The Defendants, Laurel County, Laurel County Fiscal Court and the Laurel County Board of Education, are not entitled to take credit for the amount paid to the Internal Revenue Service against the amount due under the contract to the Plaintiff, United Pacific Insurance Company.

10. The complaint herein sets forth a claim for a liquidated amount due under the referenced contract, which claim upon recovery is entitled to bear interest at the legal rate under state law. *Curtis v. Campbell*, Ky., 336 S.W.2d 355 (1960). In diversity cases in federal court, the allowance of prejudgment interest is governed by applicable state law. *Glens Falls Insurance Co. v. Danville Motors, Inc.*, 333 F. 2d 187 (6th Circuit 1964); *Alford v. Continental Casualty Co.*, 376 F.Supp. 237 (E.D. Ky. 1974).

11. The Defendant, George Cloyd, in his individual capacity, was acting within the scope of his authority as County Treasurer in making the disputed disbursement to the Internal Revenue Service by virtue of the Fiscal Court order of February 6, 1969, and is relieved of liability. *Cain v. Burroughs Adding Machine*, Ky., 203 S.W. 315 (1918); *Harrison v. Logan County*, Ky., 110 S.W. 377 (1908).

12. The Laurel County Board of Education not having been named in the caption of the contract as a party to the contract, the execution of the contract by the Board of Education was as an endorsor and guarantor.

JUDGMENT

1. The motion of the Defendant, George Cloyd, in his individual capacity, for summary judgment is hereby sustained. Said Defendant should be, and he hereby is, dismissed from the within action.

2. The motions of the Defendants, Laurel County, Laurel County Fiscal Court, and the Laurel County Board of Education, to dismiss or in the alternative for summary judgment against the Plaintiff are hereby denied.

3. The Plaintiff, United Pacific Insurance Company, should be and hereby is granted a summary judgment against the Defendants, Laurel County, Laurel County Fiscal Court, and Laurel County Board of Education, jointly and severally, in the amount of $100,833.91, interest thereon at the rate of 6% per annum from and after May 18, 1970, through March 31, 1980, interest on the said principal amount from April 1, 1980 through November 8, 1984 at the rate of 8% per annum, for a total of $197,728.39, its costs herein expended, together with interest on the total judgment granted herein from and after November 8, 1984 until paid at the rate of 10.33% per annum.

4. The motion of the Defendant, Laurel County Board of Education, for summary judgment on its Cross-Claim against the Defendants, Laurel County and Laurel County Fiscal Court, for indemnity against said Defendants in such amount as the Board of Education is required to pay as a result of the judgment granted Plaintiff herein against the Laurel County Board of Education, is hereby sustained.

5. There being no just reason for delay, this judgment shall be a final and appealable judgment.

ENTERED this 16th day of January, 1984.

/s/ William O. Bertelsman
Judge, United States District Court for the Eastern District of Kentucky

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ATTORNEYS FOR DEFENDANT, GEORGE CLOYD

APPENDIX D

United States Code, Title 26

§6321. Lien for taxes

If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such persons.

United States Code, Title 26

§6323. Validity and Priority Against Certain Persons

(i) (2) SUBROGATION.—Where, under local law, one person is subrogated to the rights of another with respect to a lien or interest, such person shall be subrogated to such rights for purposes of any lien imposed by section 6321 or 6324.

26 C.F.R. §301.6323(i)-1

(b) Subrogation—(1) In general. Where, under local law, one person is subrogated to the rights of another with respect to a lien or interest, such person shall be subrogated to such rights for purposes of any lien imposed by section 6321 or 6324. Thus, if a tax lien imposed by section 6321 or 6324 is not valid with respect to a particular interest as against the holder of that interest, then the tax lien also is not valid

with respect to that interest as against any person who, under local law, is a successor in interest to the holder of that interest.

United States Code, Title 26

§6332. Surrender of property subject to levy

(d) *Effect of honoring levy.*—Any person in possession of (or obligated with respect to) property or rights to property subject to levy upon which a levy has been made who, upon demand by the Secretary or his delegate, surrenders such property or rights to property (or discharge such obligation) to the Secretary or his delegate (or who pays a liability under subsection (c)(1)) shall be discharged from any obligation or liability to the delinquent taxpayer with respect to such property or rights to property arising from such surrender or payment. In the case of a levy which is satisfied pursuant to subsection (b), such organization shall also be discharged from any obligation or liability to any beneficiary arising from such surrender or payment.

26 C.F.R. §301.6332-1(c) (1985)

(c) *Effect of honoring levy.* Any person in possession of, or obligated with respect to, property or rights to property subject to levy and upon which a levy has been made who, upon demand by the district director, surrenders the property or rights to property, or discharges the obligation, to the district director, or who pays a liability described in paragraph (b)(1) of this section, is discharged from any obligation or liability to the delinquent taxpayer with respect to the property or rights to property arising

from the surrender or payment. If an insuring organization satisfies a levy with respect to a life insurance or endowment contract in accordance with §301.6332-2, the insuring organization is discharged from any obligation or liability to any beneficiaries of the contract arising from the surrender or payment. Also, it is discharged from any obligation or liability to the insured or other owner. Any person who mistakenly surrenders to the United States property or rights to property not properly subject to levy is not relieved from liability to a third party who owns the property. The owners of mistakenly surrendered property may, however, secure from the United States the administrative relief provided for in section 6343 (b) or may bring suit to recover the property under section 7426.

(2) (2)

Nos. 86-1772 and 86-1922

Supreme Court, U.S.
FILED
JUL 11 1987
JOSEPH F. SPANIOL, JR.
CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1987

UNITED PACIFIC INSURANCE COMPANY, PETITIONER

v.

LAUREL COUNTY, ET AL.

LAUREL COUNTY AND LAUREL COUNTY FISCAL COURT,
CROSS-PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITIONS FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

CHARLES FRIED
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Washington, D.C. 20530
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In the Supreme Court of the United States

OCTOBER TERM, 1987

No. 86-1772

UNITED PACIFIC INSURANCE COMPANY, PETITIONER

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ON PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

Laurel County, respondent in No. 86-1772, contends as cross-petitioner in No. 86-1922 that the district court erred in dismissing its third-party complaint against the United States.

1. In 1969, Y & S Construction Co. (Y & S) contracted with Laurel County for the construction of a high school building to be built in London, Kentucky. At the time the construction contract was signed, Y & S, as principal, and United Pacific Insurance Company (United), as surety, executed a performance bond in the amount of the contract price, as well as a labor and material payment bond in the same amount. Pet. App. A3.

Following Y & S's failure to submit withholding taxes on behalf of its employees, the IRS filed a notice of tax lien against Y & S on February 4, 1970, in the amount of $185,031. On March 11, 1970, a second notice of tax lien was filed by the IRS against Y & S in the amount of $162,719. On or before March 4, 1970, Y & S defaulted on the contract at a time when construction was about 75% complete. United then sent a letter to Leon Browning, the architect representing Laurel County, asking that no further contract funds be paid to Y & S or to anyone else without United's written consent. On March 15, 1970, Y & S sent letters to the Laurel County Fiscal Court and to Browning requesting that all funds due or about to be due on the contract be paid to United. Pet. App. A3.

On April 17, 1970, architect Browning certified that a contract payment was due and payable to Y & S in the amount of $116,667. On or about May 15, 1970, United made demand on the Laurel County Fiscal Court for all sums coming due under the contract. On or about May 18, 1970, the IRS served a notice of levy on the Laurel County Fiscal Court for delinquent taxes due and owing by Y & S in the amount of $100,834. Pet. App. A3-A4.

On the day the IRS levy was served, the Laurel County Fiscal Court honored it by paying the sum of $100,834 to the IRS. This amount was paid out of the School Construction Fund by a check endorsed by the County Treasurer. Prior to paying over the funds, the Treasurer had consulted two local attorneys, who advised that there might be personal liability if the levy were not honored. The Treasurer had earlier been authorized by resolution and order of the Laurel County Fiscal Court to make disbursements out of the construction fund upon certification by Browning that the said funds were due and owing. Pet. App. A4.

The Treasurer advised United of the payment to the IRS in a letter dated May 18, 1970, the day the levy was honored. Petitioner promptly protested the same. Ultimately, of the total contract price of $2,554,532, Y & S received $1,587,995; United, which completed the contract after Y & S defaulted, received $865,703; and the IRS received $100,834. Pet. App. A4.

2. United brought this suit in 1974 in the United States District Court for the Eastern District of Kentucky as a breach of contract action against Laurel County for the amount paid to the IRS. Laurel County filed a third-party complaint against the United States for indemnity and reimbursement. The district court dismissed the third-party complaint, holding that Laurel County had not complied with the nine-month limitations period for bringing actions against the United States for allegedly wrongful levies. See 26 U.S.C. 7426, 6532(c)(1); Pet. App. A4-A5.[1]

The district court next held, as a matter of Kentucky law, that the funds due under the contract had not yet become the "property" of Y & S when Laurel County paid a portion of those funds to the IRS. Because the IRS may validly

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[1] Section 7426 of the Internal Revenue Code (26 U.S.C.) provides that a third party claiming an interest in property seized for another's taxes may bring a "wrongful levy" action against the United States to have the property (or the proceeds of its sale) returned. Section 6343(b) of the Code provides that an aggrieved claimant may file, before proceeding to court, an administrative request for the return of the property. See Treas. Reg. § 301.6343-1(b)(2). United, which sat on its rights from 1970 to 1974, did not invoke either of these remedies. And, as noted in the text, the district court held that the third-party complaint could not be treated as a valid wrongful levy suit by Laurel County against the United States, since the statute of limitations on such suits is "9 months from the date of the levy" (26 U.S.C. 6532(c)(1)), and since four years had elapsed between the allegedly wrongful levy and Laurel County's filing of its third-party complaint. We are lodging with the Court 10 copies of the district court's opinion on this issue, which is not reproduced in the appendices to either the petition or the cross-petition.

levy only on "property and rights to property * * * belonging to" the taxpayer (26 U.S.C. 6331(a)), the court held that the funds were not available to satisfy Y & S's tax liabilities and hence should have been paid to United, rather than to the IRS. The court noted that 26 U.S.C. 6332(d), which discharges a custodian honoring a levy from liability "to the delinquent taxpayer," does not by its terms relieve the custodian of liability to a third party who is the true owner of the funds (Pet. App. A28). Accordingly, the court entered judgment for United against Laurel County in the amount of $100,834, plus interest.

The court of appeals reversed in part, affirmed in part, and remanded for further proceedings (Pet. App. A1-A19). It first held that the district court had erred, as a matter of Kentucky law, in ruling that Y & S did not possess any "property or rights to property" in the contract payments that could properly have been the subject of an IRS levy. Accordingly, the court concluded that Laurel County could properly have used a portion of the contract funds to satisfy a levy predicated on Y & S's unpaid tax liabilities. However, because the record did not contain a copy of the actual notice of levy (see *id.* at A4 n.2), and because the district court had not made a specific finding concerning its existence, the court of appeals remanded the case to the district court for further findings regarding the existence of a levy (*id.* at A5-A13).

As an alternative ground for its decision, the court of appeals held that federal law in any event would protect Laurel County from liability to United for erroneous payment in response to an IRS levy (Pet. App. A13-A17). Relying in party on this Court's decision in *United States* v. *National Bank of Commerce*, 472 U.S. 713 (1985), the court of appeals concluded that "where, as alleged here, the custodian of a taxpayer's property or rights to property has at the time of levy no defense for failure to comply

with the levy * * * and thus honors a lawful IRS levy, the custodian has a valid and complete defense under federal law to claims of third parties with interests in the property surrendered" (Pet. App. A16-A17). Thus, the court held that Laurel County will have a valid federal defense to United's suit if the existence of the levy is proven on remand.

Finally, the court of appeals affirmed the district court's judgment dismissing Laurel County's third-party complaint against the United States (Pet. App. A17-A21). The court explained that the third-party complaint was in substance a wrongful levy suit, which was time-barred, and that there was no basis for an interpleader proceeding (*id.* at A18-A19, A21).

3. United, in No. 86-1772, challenges the court of appeals' holding that, if it is determined on remand that a valid IRS levy was made on the contract funds, United's breach of contract action against Laurel County must fail. Because the United States was not a party to this dispute in the district court or to Laurel County's appeal on this issue in the court of appeals, we will not address this contention here in any detail. As we explained in our brief as amicus curiae below, however, we believe that the district court's judgment on this point warranted reversal. Moreover, apart from the correctness of the decision below, this case is clearly inappropriate for Supreme Court review. The case has been remanded to the district court for an additional factual inquiry, and United will prevail unless Laurel County can prove the existence of the levy. In that event, United will no longer have any interest in further review of the questions presented here. Therefore, the questions presented in the petition are not yet ripe for consideration by this Court. See, *e.g.*, *Brotherhood of Locomotive Firemen & Enginemen* v. *Bangor & Aroostook R. R.*, 389 U.S. 327, 328 (1967). In any event, the decision below, although it contains an alternative

holding based on federal law, rests independently on a construction of Kentucky law that obviously presents no question warranting this Court's attention.

4. Because Laurel County's protective cross-petition in No. 86-1922 is expressly conditioned upon the granting of certiorari in No. 86-1772 (see Cross-Pet. 8), the cross-petition should be denied if the petition in No. 86-1772 is denied. In any event, Laurel County's contention (Cross-Pet. 5-8) that the district court erred in dismissing its third-party complaint was correctly rejected by the court of appeals. Laurel County does not dispute that its complaint was time-barred if viewed as a wrongful levy action under 26 U.S.C. 7426. Rather, it claims that its third-party complaint should be treated as an interpleader action under 28 U.S.C. 2410(a)(5), a contention that was not made to the district court. This contention is without merit.

As the court of appeals explained (Pet. App. A18), an interpleader action was not available to Laurel County once it had disbursed the disputed funds in satisfaction of the levy. In the Federal Tax Lien Act of 1966, Pub. L. No. 89-719, § 201, 80 Stat. 1147, Congress extended the existing waiver of sovereign immunity, which covered suits to quiet title or suits to foreclose a lien in which the United States claimed an interest, to the analogous situations of condemnation, partition, and suits in the nature of interpleader. Congress explained that "[i]nterpleader actions are those brought *by persons holding property* for the purpose of determining who is entitled to the property held." S. Rep. 1708, 89th Cong., 2d Sess. 33 (1966) (emphasis added). Thus, the waiver of sovereign immunity in 28 U.S.C. 2410(a)(5) is restricted to situations where the suit is brought by the stakeholder of disputed property. It does not extend to a suit to recover property now in possession of the government simply because the plaintiff was once in the position of stakeholder.

It is therefore respectfully submitted that both the petition and the cross-petition for a writ of certiorari should be denied.

CHARLES FRIED
Solicitor General

JULY 1987

U.S. GOVERNMENT PRINTING OFFICE: 1987 — 181-483/40421

No. 86-1772

Supreme Court, U.S.
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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1986

UNITED PACIFIC INSURANCE COMPANY
Petitioner

v.

LAUREL COUNTY, and LAUREL COUNTY FISCAL COURT
Respondents

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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QUESTION PRESENTED

Whether construction project owners are liable to the general contractor's surety for progress payments which have been seized by IRS levy.

STATEMENT UNDER RULE 28.1

A list of parties has been provided by United Pacific in its Petition, and by Laurel County and Laurel County Fiscal Court in their Cross-Petition in Case No. 86-1922.

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STATUTES INVOLVED

In addition to the statutes cited by United Pacific in its Petition, and by these Respondents in their Cross-Petition, this case involves the construction and application of 26 USC §6331. The text of the relevant portion of that statute is reproduced in the Appendix.

CITATIONS

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COUNTERSTATEMENT OF THE CASE

On February 4 and March 11, 1970, the IRS filed tax liens against Y & S Construction Company, Inc., the contractor on the Laurel County High School Construction project, for unpaid withholding taxes for the third and forth quarter of 1969. On March 31, the contractor submitted application for a monthly progress payment, for work completed on the project. The architect certified such payment on April 17, and the certificate was forwarded to the Laurel County Board of Education for the issuance of the check by the County Treasurer.

On May 18, 1970, the IRS revenue officer served the County Treasurer with a tax levy on all property or rights to property of Y & S Construction Company, Inc. held by the project owners. The revenue officer had visited the Treasurer, Mr. Cloyd, several days earlier with a previous levy, and was put off by Mr. Cloyd until he obtained legal advice. On May 18, a check was issued to the IRS for $100,833.91 against the Y & S Construction Company project account and given to the revenue officer. The same day, the County Treasurer sent notice to United Pacific of the amount paid to the Internal Revenue Service pursuant to the levy. The surety was thus given notice on the day of payment that contract funds in which it claimed an interest, had been transferred to the IRS by the honoring of the levy.

Although the surety objected to the project owners of such payment, the surety apparently did not seek to recover such funds from the IRS, either administratively under 26 U.S.C. §6343, or by filing suit pursuant to 26 U.S.C. §7426.

After the Sixth Circuit's Opinion remanding to the Trial Court for further proceedings, Mr. Cloyd's deposition was taken as evidence on February 24, 1987. There was also tendered to the Trial Court by Affidavit, a copy of the check making payment to the IRS from the construction funds for the amount in question and showing that payment was made pursuant to IRS levy. Mr. Cloyd made clear in his testimony that he knew the difference between the tax lien documents filed in the County Clerk's Office, and the IRS levy served upon him by the revenue officer.

On remand from the Sixth Circuit, Laurel County and its Fiscal Court have moved the Trial Court for Summary Judgment based upon the deposition of Mr. Cloyd and the Affidavit and check. United Pacific has responded to the motion and the matter stands submitted before the District Court.

REASONS FOR DENYING THE WRIT

1. THERE IS NO BASIS FOR GRANTING THE PETITION SINCE THE SIXTH CIRCUIT'S OPINION DOES NOT AFFECT THE DOCTRINE OF EQUITABLE SUBROGATION.

The basis of United Pacific's argument rests on *Pearlman v. Reliance Insurance Company*, 371 U.S. 132 (1962). However, the Sixth Circuit's opinion does not conflict with the principles in *Pearlman*, and the opinion is in harmony with the doctrine of equitable subrogation. This Court in *Pearlman* declared that a surety, having paid laborers and materialmen, was entitled to be subrogated to their rights against the contract retainage to the extent necessary for its reimbursement. That doctrine is not disputed in the present case. The Sixth Circuit merely held that the surety had no claim against the project owners for breach of contract, where the owners honored an IRS levy. That holding did not diminish the surety's rights. The Sixth Circuit recognized that any claim the surety had against the owners was not because of their status as owners, but because of their custodial possession of the progress payment. When those funds were seized by the IRS, the surety's claim against the project owners was extinguised, and transferred to the new custodian, the IRS. Because funds in the hands of the IRS are governed by federal statute, the surety was obliged to comply with the statute to keep its claim alive. This the surety did not do.

The rights claimed by United Pacific as surety, under the doctrine of subrogation, are not self-enabling. To perfect its claim the surety must take some positive step to preserve and defend its claim. After the seizure by the IRS, the immediate notice given by the County Treasurer to the surety (see

Appendix) was sufficient warning to advise it of the IRS's competing claim to the funds. The tax code provided remedies to the surety in Sections 6343 and 7426. By taking no action until the statute of limitations expired, the surety slept on its rights, and failed to guard and sustain its claim in the property.

2. THE SURETY SEEKS EQUITY WITHOUT HAVING DONE EQUITY.

The surety seeks to divert this Court's attention from the issues disputed in the case. The Sixth Circuit did not address issues of equitable subrogation since such questions were not involved or challenged. Its opinion did not affect this surety's subrogation rights.

Subrogation is an equitable remedy. United Pacific suggests, on Page 8 of its Petition, that "subrogation" is synonymous with "equitable lien." In order for a party to invoke the equitable powers of the Court, it must first do equity. A recognized principle is that, "Equity aids the vigilant, and not one who has slept on his rights." The doctrine imposes upon a surety the duty to take all reasonable steps to mitigate his own damages, and not to exacerbate them. United Pacific, possessed with a claim against the monthly draw, failed to take steps to perfect that claim. When the County Treasurer advised the surety that the funds have been seized by the IRS, the surety took no action and allowed its claim against the funds to expire.

Sections 7426 and 6343 of the tax code were the methods available to the surety for perfecting its interest in the funds. United Pacific cannot claim ignorance of those methods, since it was involved in a

§7426 action itself in *United Pacific Insurance Company v. United States,* 320 F. Supp. 450 (D.C. Ore, 1970) at the same time as this case. If the surety had taken steps to perfect its claim under either section of the tax code, there would have been no need for this present action, and the adverse claims between the surety and the IRS would have been resolved years ago without the involvement of Laurel County and its Fiscal Court. The surety seeks the equity of subrogation, but has not accomplished the equity of mitigation.

3. AN IRS LEVY DOES NOT DETERMINE PROPERTY RIGHTS SO THAT A CUSTODIAN IS NOT LIABLE IN CONVERSION.

The foundation of the Sixth Circuit's opinion is its holding that,

> A payment made by a custodian of property in which the taxpayer has an interest pursuant to an IRS administrative levy is a valid defense to a subsequent action by a third party claiming an interest in the property.

In *Dederman v. Jenkins,* 111 F.Supp 604 (N.D. Ga., 1953), the Court found the holder of funds not liable to the true owner in conversion when the holder paid the funds to the IRS pursuant to levy with knowledge of the owner's claim. The Court reasoned that the stakeholder was not required to determine the true owner of the funds before honoring the levy. A bank, holding funds of the taxpayer in *DeEdwardo v. First*

National Bank of Bath, 442 F.Supp. 499 (E.D. Pa., 1977), was not liable in conversion for paying an IRS levy. The Court held that the honoring of the tax levy was a complete defense to the claim brought by a third party claiming true ownership to the funds.

This Court in *United States v. National Bank of Commerce,* 472 U.S. 713, 105 S.Ct. 2919, 84 L.Ed. 2d 565 (1985), observed that,

> The levy does not determine whether the government's rights to the seized property are superior to those of other claimants., L.Ed. 2d at page 574.

The Courts recognized that the levy does not determine priority or decide property interests in the property which has been seized. The seizure pursuant to levy entitles the IRS to possession, but not necessarily to ownership. This Court stated further that,

> The administrative levy, as has been noted, is only a provisional remedy. 'The Final Judgment in [a levy] action settles no rights in the property subject to seizure.', id, page 578.

The IRS' power to seize property pursuant to a tax levy is derived from 26 U.S.C. §6331. This Court stated explicitly that the tax levy,

> Is a provisional remedy, which does not determine the rights of third parties until after the levy is made, in post-seizure administrative or judicial hearings., id, page 581.

This Court suggested in *National Bank of Commerce* that a suit such as this one, is not proper. One

honoring a lawful levy is discharged by making payment pursuant to the levy, from liability to a third party claiming an interest in the property.

> Nor would the Bank be exposed to double liability were it to honor the IRS levy. The code provides administrative and judicial remedies for co-depositors against the government, and any attempt to secure payment in this situation from the Bank itself would be contrary to the federal enforcement scheme. id, page 579.

The administrative remedies available in Section 6343, and the judicial remedies in Section 7426 were not invoked by United Pacific.

In Footnote 13, Justice Blackman suggests that, "Any attempt to recover against the Bank under state law would be preempted." This case originated as such a suit. The Sixth Circuit followed Justice Blackman's reasoning by reversing that portion of the district court's judgment to the contrary.

4. THE TAX CODE PROVIDES SUFFICIENT REMEDY FOR ONE CLAIMING AN INTEREST IN FUNDS SEIZED BY LEVY.

Rather than abrogating the rights of the surety, the Sixth Circuit's opinion reaffirms those rights. An action instituted under Section 7426 must be brought by a person who claims an interest in the property wrongfully levied. The county agencies, as project owners, claimed no interest in the funds. By contract, monthly payments were not eligible for distribution

until and unless the architect certified that the work for which the payment was generated had been performed. The County, having received the benefit of the construction work, had no further claim on the monthly draw, and merely held funds for proper distribution to the contractor. Because of its subrogation rights, the surety qualified as a party "who claims an interest in or a lien on such property" under 7426. The county agencies on the other hand had no standing under either Section 6343 or 7426 to seek a return of the levied funds, since they claimed no interest in the funds. The nine month statute of limitations provided in 26 U.S.C. §6532 therefore applied to the surety, but not to the county agencies.

The very existence of 26 U.S.C. §6343 and §7426 presupposes that the IRS may not always enjoy an unrestricted or unencumbered claim to property seized by levy. The purpose of the levy is to promote the speedy collection of taxes to the government. In exchange for that right, Congress created procedures for third parties to protect their claimed interest in the seized property. That is the purpose of Sections 6343 and 7426. In this case, the surety failed to preserve its interest in the contract funds by either statutory method until the statute of limitations had expired.

Since the tax code provided avenues by which the surety could have protected its claim, a situation like the one in the present case will only arise when a surety sleeps on its rights or abandons its claim and later seeks redress from the funds custodian. Such problems will not occur unless a surety fails to pursue its claim. Presumably, such laxity is not as pervasive throughout the construction industry as it was by the surety in the present case.

CONCLUSION

The Petition for Writ of Certiroari should be denied. Since an IRS levy does not determine property rights, the surety's rights of equitable subrogation were not diminished by the Sixth Circuit's opinion. The Tax Code provided the surety with adequate means and methods of protecting its claim, and the project owners are not liable for the surety's failure to preserve its interest in the progress payment.

Respectufully submitted,

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CERTIFICATE OF SERVICE

The undersigned does hereby certify that three copies of this Brief in Opposition to Petition for Writ of Certiorari were served by mail to Hon. Bernard L. Balkin and Hon. Keith Witten, Sandler, Balkin, Hellman & Weinstein, P.C., 3130 Broadway, Third

Floor, Kansas City, Missouri 64111; Hon. William Gary Crabtree, 120 E. Fourth Street, P.O. Box 428, London, Kentucky 40741; Hon. Roger M. Olson, Assistant Attorney General, Department of Justice, Washington, D.C. 20530; Hon. Louis De Falaise, United States Attorney, Eastern District of Kentucky, Federal Building, Lexington, Kentucky 40507 and Hon. Charles Fried, Solicitor General, Department of Justice, Washington, D.C. 20530, on this 2nd day of July, 1987.

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COUNSEL FOR RESPONDENTS

APPENDIX

May 18, 1970

United Pacific Insuracne Company
Post Office Box 13,405
Kansas City, Missouri 64100

Gentlemen:

We enclosed herewith two checks in payment of the following amounts due Y & S Construction Company, Inc., and Laurel County School Building Fund.

Payment number 13; amount due	$116,666.59
less amount paid on I.R.S. levy	100,833.91
Amount due on Y & S on payment #13	$15,832.68
Payment number 14; amount due	$172,989.00

Very truly yours,

George W. Cloyd
Laurel County Treasurer
London, Kentucky 40741

GWC:wh

Enclosure

§6331. Levy and distraint

(a) Athority of Secretary or delegate.--If any person liable to pay any tax neglects or refuses to pay the same within 10 days after notice and demand, it shall be lawful for the Secretary or his delegate to collect such tax (and such further sum as shall be sufficient to cover the expenses of the levy) by the levy upon all property and rights to property (except such property as is exempt under section 6334) belonging to such person or on which there is a lien provided in this chapter for the payment of such tax. Levy may be made upon the accrued salary or wages of any officer, employee, or elected official, of the United States, the District of Columbia, or any agency or instrumentality of the United States or the District of Columbia, by serving a notice of levy on the employer (as defined in section 3401 (d) of such officer, employee, or elected official. If the Secretary or his delegate makes a finding that the collection of such tax is in jeopardy, notice and demand for immediate payment of such tax may be made by the Secretary or his delegate and, upon failure or refusal to pay such tax, collection thereof by levy shall be lawful without regard to the 10-day period provided in this section.

(b) Seizure and sale of property.--The term "levy" as used in this title includes the power of distraint and seizure by any means. A levy shall extend only to property possessed and obligations existing at the time thereof. In any case in which the Secretary or his delegate may levy upon property or rights to property, he may seize and sell such property or rights to property (whether real or personal, tangible or intangible).